MORNING BRIEFING
December 3, 2019

Signs of Life & Death

See the pdf and the collection of the individual charts linked below.

(1) The Great Inflation of the 1970s is long behind us. (2) Is inflation dead or just in a coma and on life support provided by the central banks? (3) The Fed's delusional "make-up" strategy for inflation. (4) ECB ready to fine-tune inflation target. (5) BOJ out of ammo. (6) Central bankers want fiscal policy to take over. (7) China catches the swine flu. (8) Looking for a pulse in the global economy. (9) China's lukewarm stir-fry. (10) German auto industry reducing payrolls. (11) US consumers on spending spree that has yet to trickle down to manufacturing.

Global Inflation: Still in a Coma. I've been a disinflationist since the early 1980s. I first used that word, which means falling inflation, in my June 1981 commentary, "Well on the Road to Disinflation." The Consumer Price Index (CPI) inflation rate was 9.6% y/y that month (*Fig. 1*). I predicted that Fed Chair Paul Volcker would succeed in breaking the inflationary uptrend of the 1960s and 1970s when he adopted a monetarist approach during October 1979. I certainly wasn't a monetarist, given my Keynesian training at Yale. I knew that my former boss at the Federal Reserve Bank of New York wasn't a monetarist either. But I expected that Volcker would use this radical approach to push interest rates up as high as necessary to break the back of inflation. Which is exactly what happened.

Ever since then, reflationists have been predicting, without any success, that inflation is bound to make a comeback. They've been wrong for so long because inflation is so yesterday. The Great Inflation was basically a 1970s phenomenon attributable to the two oil price shocks of 1973 and 1979 (*Fig. 2*). Thanks to cost-of-living clauses in private-sector union contracts back then, those price shocks were passed directly to wages, causing a wage-price spiral (*Fig. 3*).

The CPI isn't the best measure of price inflation because it has a significant upward bias. The Fed prefers the core personal consumption expenditures deflator (PCED), which better reflects the prices of the goods and services that consumers are actually buying. According to this measure, inflation has ranged between a low of 0.9% and a high of 2.6% since 1995 (*Fig. 4*).

In recent years, I've often declared: "Inflation is dead." I've frequently discussed the four deflationary forces (which I call the "4Ds") that have killed it. They are détente, disruption, demography, and debt. The data show that at best inflation is in a coma, especially in the major industrial economies. Here is an update on the latest inflation readings:

(1) *US CPI and PCED.* In the US, the headline and core CPI were up 1.8% and 2.3% y/y, respectively, in October. However, the comparable readings for the PCED were only 1.3% and 1.6% (*Fig. 5*).

Now sit down for this one: The Fed is seriously considering a "make-up" strategy for targeting inflation. That's according to yesterday's *FT* article "US Federal Reserve considers letting inflation run above target." Here is the gist of the plan: "The Fed's year-long review of its monetary policy tools is due to conclude next year and, according to interviews with current and former policymakers, the central bank is considering a promise that when it misses its inflation target, it will then temporarily raise that target, to make up for lost inflation."

With all due respect, that's hilarious! Why do Fed officials want to embarrass themselves by targeting inflation over 2.0% when they haven't been able to move it up to 2.0% since officially targeting that level in January 2012? Fed Governor Lael Brainard, speaking to reporters last week, said that a strict make-up rule would be too hard to explain to the public. I think she is right.

Since January 2012, the headline PCED has been tracking a 1.3% annual trendline (*Fig. 6*). In other words, October's PCED was 4.7% below where it should have been if it had been tracking 2.0%. To get back to the steeper trendline by the end of 2022, the PCED would have to increase by about 12.0%, or 4.0% per year! Try explaining that to the public.

By the way, the big divergence between the CPI and PCED inflation rates during October was mostly attributable to consumer durables (up 0.5% in the CPI and down 1.0% in the PCED) (*Fig. 7*). In addition, medical care services was up much more in the CPI (5.1%) than in the PCED (2.1%) (*Fig. 8*). These divergences are par for the course—they are not unusual. Rent inflation tends to be almost identical in the CPI and the PCED, but it has a much higher weight in the former than the latter, and it has been running hotter (at 3.7%) than the overall inflation rate (*Fig. 9*).

(2) *Eurozone CPI.* An 11/28 Bloomberg article reported that the European Central Bank (ECB) is expected to "tweak" its inflation target in an upcoming review of monetary policymaking: "The institution's first fundamental assessment in 16 years might conclude with a goal of 2%—instead of the current 'below, but close to, 2%' which some governors worry risks leaving inflation too weak." One word comes to mind: "Lame."

During November, the Eurozone's CPI inflation rate picked up to 1.0% from a three-year low of 0.7% in October (*Fig. 10*). The core rate was 1.3%, the highest in seven months.

On 11/22/19, Christine Lagarde delivered her first speech as ECB president, "The future of the euro area economy." Remarkably, she spoke about monetary policy almost in passing, in just one paragraph in fact. Instead, she presented a case for fiscal policy to focus on more public investments in infrastructure, R&D, and education. She also said she wants to see more economic integration in the EMU. She is one of the few central bankers who seems inclined to acknowledge that monetary policy may have lost its effectiveness.

(3) *Japan CPI.* An 11/18 Bloomberg article reported that the Bank of Japan (BOJ) may be running out of ammo to boost inflation in Japan: "Speaking in parliament on Tuesday, [Bank of Japan Governor Haruhiko] Kuroda said there was still room to lower interest rates further, but added that he had never claimed the BOJ's easing ammunition was endless or that there was no limit on how low rates could go."

In fact, he is running out of support for additional monetary stimulus measures.
The article observed: "Such low yields have gradually pushed institutional investors and regional banks out of the JGB market and into riskier assets. Many analysts see bankruptcies looming among beleaguered regional banks, where the old model of borrowing short and lending long has been upended both by a flat yield curve and a diminished demand for credit."

The BOJ has been reluctant to follow its peers around the world in easing policy this year, suggesting that the days of shock and awe from Kuroda's BOJ are over. There is more talk about doing more to stimulate the economy with fiscal policy, but it's all talk so far.

Meanwhile, Japan's CPI inflation rate is on life support. The headline rate was up just 0.2% during October (*Fig. 11*). The core rate, which includes oil costs but excludes volatile fresh food prices, rose 0.4% y/y in October. Excluding the impact of the sales tax hike rolled out in October and the introduction of free childcare, annual core consumer inflation was 0.2% in October, slowing from 0.3% in September.

(4) *China CPI.* China's headline CPI inflation rate jumped to 3.8% during October (*Fig. 12*). That was the highest since January 2012. However, it was boosted by soaring pork prices, which lifted overall food-price inflation to a more-than-11-year high, as consumer demand drove up prices for pork alternatives including eggs and other meat products. Hog prices have soared this year at the fastest pace on record as a result of the deadly African swine flu. Excluding food, the CPI was up just 0.9% during October!

Global Economy: A Faint Pulse. While inflation in the major economies remains comatose, the global economic slowdown may be coming to an end, as more global economic indicators are showing some signs of life. However, post-bottom growth appears so far to be tracing an L-shaped recovery rather than either a U-shaped or V-shaped one. This is consistent with our view that global growth is being weighed down by aging demographic trends and too much debt.

Much of the weakness since early last year has been in global manufacturing, which may also be bottoming. Trump's trade wars have been blamed for the global factory recession. Debbie and I suspect that there may also be a more structural problem: The global economy is stuffed with too much stuff. Both young adults and seniors are becoming minimalists, so they're buying less stuff (like autos), leaving too much manufacturing capacity relative to the slowing demand.

Let's review the latest global indicators:

(1) *China*. When we stir-fry China's latest batch of PMIs for November, it's a slightly warmer mix than October's. The official M-PMI rose to 50.2 last month, the first reading above 50.0 since April (*Fig. 13*). The NM-PMI rose to 54.4, the best reading since March.

Two of the components of the M-PMI were solidly above 50.0, with output at 52.6 and new orders at 51.3 (*Fig. 14*). On the other hand, the employment component was only 47.3.

Now the bad news: Profits at China's industrial firms continued to fall in October, posting their steepest decline since 2011 as producer prices remained weak and trade tensions with the US weighed on China's economy. Industrial profits plummeted 9.9% y/y during October. It was the third straight monthly decline. The PPI was down 1.6% y/y during October, the weakest since July 2016.

(2) *Eurozone*. Whoopie: The Eurozone's Economic Sentiment Indicator (ESI) ticked up during November (*Fig. 15*). You need a magnifying glass to see it, and there have been similar upticks along the way down from the ESI's peak of 114.5 at the end of 2017 to November's 101.3. The ESI is highly correlated with the y/y growth in the region's real GDP, which slowed to 1.2% during Q3.

The good news is that the Eurozone's M-PMI stopped falling during September, when it bottomed at 45.7. It rose to 46.9 during November. The bad news is that it has been below 50.0 since February. Germany's M-PMI has recovered from a low of 41.7 during September to 44.1 last month. France's rose to 51.7 and has managed to stay mostly above 50.0 since the start of this year (*Fig. 16*).

Oops: At the end of last month, Audi announced a cut of 9,500 of its 61,000 jobs in Germany. Daimler said it would shed at least 10,000 jobs of nearly 300,000 worldwide. Both claimed they were reducing payrolls to fund the switch to electric cars.

(3) *US*. US consumers have started the holiday shopping season by spending like they all have jobs and record real pay (which they do). New home sales in October (733,000 units) barely budged from September's 738,000 units (saar), which was the best pace since July 2007.

Yet the US M-PMI edged down from 48.3 in October to 48.1 during November, the fourth consecutive monthly reading below 50.0 (*Fig. 17*). Weakness was widespread. Of the 18 manufacturing industries, only five reported growth in November. The New Orders Index fell from 49.1 to 47.2. The Employment Index declined from 47.7 to 46.6. The New Exports Index (47.9) and Imports Index (48.3) remained below 50.0 (*Fig. 18*).

CALENDARS

US. Tues: None. **Wed:** ADP Employment 140k, ISM & IHS Markit NM-PMIs 54.5/51.6, MBA Mortgage Applications, DOE Oil Inventories, Quarles. (DailyFX estimates)

Global. Tues: Australia GDP, Japan C-PMI & NM-PMI, China C-PMI & NM-PMI. **Wed:** Eurozone C-PMIs & NM-PMIs, UK C-PMI & NM-PMI, BOC Rate Decision 1.75%m. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): The forward earnings of MidCap and SmallCap rose for a second week in a row, but LargeCap's dropped after rising a week earlier for the first time in seven weeks. These indexes began a forward-earnings uptrend during March, but only LargeCap is near a record high. LargeCap's forward earnings has risen during 29 of the past 42 weeks, MidCap's 21 of the past 38 weeks, and SmallCap's 19 of the past 36 weeks. LargeCap's is just 0.4% below its record high 11 weeks ago, while MidCap's and SmallCap's are 5.5% and 9.4% below their October 2018 highs. MidCap's forward earnings is near an 18-month low now, while SmallCap's forward earnings is near September's 17-month low because analysts are now including a large goodwill writeoff in their 2019 annual forecast for Frontier Communications. At their bottoms earlier in 2019, LargeCap's forward EPS had been the most below its record high since June 2016 and MidCap's was the lowest since May 2015. During mid-September, SmallCap's had not been this far below since October 2010. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act but began to tumble in October as y/y comparisons became more difficult. In the latest week, the rate of change in LargeCap's forward earnings dropped to 1.1% y/y from 1.3%. That's close to mid-November's 38-month low of 1.0% and down from 23.2% in September 2018, which was the highest since January 2011. MidCap's was steady w/w at -5.1% y/y, and compares to -5.5% in mid-November, which was the lowest since December 2009. That also compares to 24.1% in September 2018 (the highest since April 2011). SmallCap's -7.3% y/y change is up from -9.6% in mid-September, which was the lowest since December 2009 and compares to an eight-year high of 35.3% in October 2018. Analysts had been expecting double-digit percentage earnings growth for 2019 last October, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, 0.2%, 9.9%), MidCap (22.7, -7.3, 12.3), and SmallCap (22.4, -19.5, 36.5).

S&P 500/400/600 Valuation (*link*): Valuations rose for the seventh time in eight weeks for these three S&P market-cap indexes to their highest levels in over a year. LargeCap's forward P/E rose 0.2pt w/w to a 22-month high of 17.7 from 17.4. That compares to a five-year low of 13.9 during December 2018 and a 16-year high of 18.6 during January 2018—and of course is well below the tech-bubble record high of 25.7 in July 1999. Last week's level remains above the post-Lehman-meltdown P/E of 9.3 in

October 2008. MidCap's forward P/E was up 0.2pt w/w, to a 21-month high of 17.1. That's up from 13.0 during December 2018, which was the lowest reading since November 2011. MidCap's P/E is down from a 15-year high of 19.2 in February 2017 and the record high of 20.6 in January 2002. However, MidCap's P/E has been at or below LargeCap's P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap's P/E jumped 0.4pt to a 14-month high of 17.9. That's well above its seven-year low of 13.6 during December 2018 and compares to its 15-year high of 20.5 in December 2016, when Energy's earnings were depressed. SmallCap's P/E was above LargeCap's for the sixth time in seven weeks. It had been below for four months through the end of August—the first time that has happened since 2003.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): With the Q3 earnings season approaching the finish line, the Q4 EPS forecast dropped 22 cents w/w to $40.81. That represents a decline of 0.9% on a frozen actual basis and a drop of 0.1% y/y on a proforma basis. That compares to a 1.0% decline in Q3 and y/y gains of 3.2% in Q2, 1.6% in Q1, 16.9% in Q4-2018, and 28.4% in Q3-2018 (which marked the peak of the current earnings cycle). If the y/y earnings decline comes to pass in Q4-2019, it would be the second straight decline and the first drop since earnings fell y/y for four straight quarters through Q2-2016. However, seven of the 11 sectors are expected to record positive y/y earnings growth in Q4, with two rising at a double-digit percentage rate. That compares to seven positive during Q3, when none rose at a double-digit percentage rate. The same seven sectors are expected to beat the S&P 500's 0.9% decline in Q4 as in Q3; that's up sharply from just three beating the S&P 500 during Q2. Six sectors are expected to post improved growth on a q/q basis during Q4: Communication Services, Energy, Financials, Materials, Tech, and Utilities. On an ex-Energy basis, the consensus expects earnings to rise 2.2% y/y in Q4. That compares to ex-Energy gains of 2.2% in Q3, 3.9% in Q2, and 3.0% in Q1. However, that's well below the 25.0% and 14.2% y/y gains in Q3- and Q4-2018, respectively. Here are the latest Q4-2019 earnings growth rates versus their nearly final Q3-2019 growth rates: Utilities (14.7% in Q4-2019 versus 6.7% in Q3-2019), Financials (12.4, 2.3), Health Care (6.1, 8.8), Real Estate (3.8, 5.6), Communication Services (1.8, -1.5), Consumer Staples (0.6, 3.6), Information Technology (0.4, -1.8), Industrials (-4.7, 3.6), Materials (-7.7, -11.0), Consumer Discretionary (-12.0, 1.8), and Energy (-33.9, -37.8).

US ECONOMIC INDICATORS

Construction Spending (*link*): Construction expenditures in October fell for the second month as private construction spending sank to a three-year low—though single-family construction continued to soar. Overall investment fell 0.8% following a downwardly revised 0.3% decline in September—first reported as a 0.5% increase. Private construction spending dropped 2.1% during the two months ending October, while public construction expenditures dipped 0.2% in October after a three-month climb of 1.9%. The latter is up 11.0% ytd. Within private construction spending, single-family construction rose for the fourth straight month, up 5.6% over the period, after falling 12 of the prior 13 months by a total of 10.9%. Meanwhile, multi-family investment contracted 6.6% during the five months through October, while home-improvement spending plunged 9.0% the past two months, after moving sideways most of this year. Private nonresidential building sank 1.1% in October following a similar decline in September, slipping just below zero ytd.

GLOBAL ECONOMIC INDICATORS

Global Manufacturing PMIs (*link*): Global manufacturing activity in November expanded slightly, moving back above the 50.0 line dividing expansion from contraction for the first time since April. JP Morgan's M-PMI (to 50.3 from 49.8) climbed to a seven-month high, as the emerging nations' M-PMI continued to improve, from 49.9 in June to 51.0 in November, while the M-PMI (to 49.6 from 48.6) for developed nations is nearing expansionary territory for the first time in seven months. Eleven of the nations for which November PMI data are available registered expansions, with the strongest growth occurring in Greece (54.1), Colombia (52.9), and Brazil (52.9); the US (52.6), China (51.8), and France (51.7) rounded out the top six. The Eurozone's (46.9) M-PMI improved for the third month, though continues to contract—with only Greece and France expanding. Germany (44.1), Austria (46.0), and Spain (47.5) were the bottom three in November, though growth in all was less negative in November. Meanwhile, M-PMIs for Italy (47.6), the Netherlands (49.6) , and Ireland (49.7) moved further below 50.0.

US Manufacturing PMIs (*link*): Manufacturing activity in November contracted for the fourth month, according to the ISM survey—though ISM notes last month's reading is consistent with roughly a 1.5% annualized increase in real GDP, based on the past relationship of the two measures. Meanwhile, IHS Markit's measure accelerated for the third month, growing at its fastest pace in seven months. ISM's M-PMI (to 48.1 from 48.3) shows manufacturing activity is little changed around September's 47.8, which was the weakest performance since June 2009. Last month, manufacturers saw new orders (47.2 from 49.1) and production (49.1 from 46.2) continue to decline, though the latter moved up closer to the breakeven point of 50.0, while the former matched its weakest rate since June 2012. Factory employment (46.6 from 47.7) was in contractionary territory for the fourth month, down from a high for this year of 57.5 in March. The remaining two index components showed that supplier deliveries (52.0 from 49.5) rebounded back above 50.0 after falling below in October for the first time since February 2016, while inventories (45.5 from 48.9) contracted at the fastest pace since May 2016. IHS Markit's M-PMI improved for the third month from 50.3 in August to 52.6 by November, indicating manufacturing is pulling out of its soft patch. Both new orders and output expanded at their best rates since January, though growth remains subdued. IHS Markit warns, "Firms remain very concerned about the disruptive effects of tariffs and trade wars in particular, both in terms of rising prices and weakened demand, though the survey also saw further worries among manufacturers that the economy could slow in the upcoming presidential election year as customers delay spending and investment decisions."

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